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John J. Finnigan, Jr.  
Senior Counsel

VIA OVERNIGHT MAIL  
January 28, 2005

Elizabeth O'Donnell  
Executive Director  
Kentucky Public Service Commission  
211 Sower Blvd.  
Frankfort, Kentucky 40602-0615

RECEIVED

JAN 31 2005  
PUBLIC SERVICE  
COMMISSION

Re: Notice of Intent to Use Market Clearing Price

Dear Ms. O'Donnell:

In accordance with Section 4.02b of the Purchase, Sale and Operation Agreement (PSOA), as endorsed by the Kentucky Public Service Commission (KyPSC) in its December 5, 2003 Order in Case No. 2003-00252,<sup>1</sup> The Union Light, Heat and Power Company (ULH&P) has concluded that a reliable and transparent hourly clearing price for setting the price for System Energy Transfers between the Parties to the PSOA will be in existence upon the operation of the Midwest Independent Transmission System Operator, Inc.'s (MISO) energy markets, generally referred to as MISO Day 2, currently scheduled to begin March 1, 2005. ULH&P has attached a copy of the PSOA, as filed with the Federal Energy Regulatory Commission (FERC).<sup>2</sup>

On January 11, 2005, ULH&P received a deficiency letter from FERC with respect to ULH&P's PSOA filing (attached). FERC has required a response to this deficiency letter within fifteen days, by January 26, 2005. ULH&P has responded to FERC's deficiency letter by seeking FERC approval to use the MISO Day-2 market clearing prices for any System Energy Transfers between the Parties to the PSOA, rather than the hourly market price methodology spelled out in the PSOA.


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<sup>1</sup> See *In the Matter of the Application of the Union Light, Heat and Power Company for a Certificate of Public Convenience to Acquire Certain Generation Resources and Related Property; for Approval of Certain Purchase Power Agreements; for Approval of Certain Accounting Treatment; and for Approval of Deviation from Requirements of KRS 278.2207 and 278.2213(6)*, Case No. 2003-00252 (Order issued December 5, 2003).

<sup>2</sup> ULH&P and The Cincinnati Gas & Electric Company jointly filed for FERC approval of the PSOA on September 27, 2004. See FERC Docket No. ER04-1248.

ULH&P has served upon the KyPSC its filed response to FERC's deficiency letter under separate cover. Another copy of this letter is enclosed herein, for your convenience.

Respectfully submitted,

  
John J. Finnigan, Jr.

cc: Hon. Elizabeth Blackford (w/enclosure)  
Hon. Anita Mitchell (w/enclosure)  
Hon. A. W. Turner (w/enclosure)

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2005 JAN 26 P 4:08

FEDERAL ENERGY  
REGULATORY COMMISSION

January 26, 2005

Magalie R. Salas  
Secretary  
Federal Energy Regulatory Commission  
888 First Street, N.E.  
Washington, D.C. 20426

RE: Union Light, Heat and Power Company and Cincinnati  
Gas & Electric Company, Docket No. ER04-1248-000

Dear Ms. Salas:

The Union Light, Heat and Power Company ("ULH&P") and The Cincinnati Gas & Electric Company ("CG&E") (CG&E and ULH&P collectively the "Filing Parties"), hereby respond to the deficiency letter issued on January 11, 2005 in this proceeding. The deficiency letter requests additional information related to the Purchase, Sale and Operation Agreement ("PSOA") that CG&E and ULH&P filed on September 27, 2004. Specifically, the deficiency letter directs the Filing Parties to provide "actual data showing comparable purchase and sale prices which demonstrate that the PSOA pricing meets at least one of the three standards identified in" *Boston Edison Co. Re: Edgar Elec. Energy Co.*, 55 FERC ¶ 61,382 (1991) ("*Edgar*").

The Filing Parties continue to believe that the PSOA is consistent with *Edgar* for all of the reasons explained in the September 27 filing, and that no further showing should be required. Transmittal Letter, Docket No. ER04-1248-000 at 6-9 (September 27, 2004). Nonetheless, to assuage the Commission's concerns about the pricing of inter-affiliate transfers of energy under the PSOA, and since the Filing Parties expect in any event that the PSOA would not become effective until April 1, 2005 at the earliest, the Filing Parties commit to defer the effectiveness of the PSOA until the Midwest Independent Transmission System Operator, Inc.'s ("Midwest ISO") Day 2 market becomes effective, and propose, as described herein, to substitute MISO Day 2 market clearing prices for the hourly market price methodology currently described in the PSOA.

The PSOA provides that when a reliable hourly market clearing price becomes available, that price will be used to price energy transfers under the agreement. Therefore, once the Midwest ISO Day 2 market become operational all energy sales under the PSOA (the only sales that occur under the agreement) will be priced at the day-ahead or real-time market price as applicable at the time of the sale. As the Filing Parties will explain, use of Midwest ISO Day 2 market prices complies with the goals and purposes of *Edgar*; is consistent with Commission precedent finding that no affiliate abuse concerns arise when prices are tied to an established, relevant market price or by reference to competitive prices at recognized market hubs; and reflects direct head-to-head competition between affiliated and unaffiliated suppliers.

**I. Energy Sales Under The PSOA Will be Made at Midwest ISO Day 2 Market Prices**

The PSOA provides the terms and conditions pursuant to which certain generating facilities being transferred by CG&E to ULH&P (the "Plants") will continue to be jointly dispatched with the facilities of CG&E and PSI Energy, Inc. ("PSI").<sup>1</sup> Pursuant to the PSOA, ULH&P will be treated the same as CG&E and PSI for purposes of joint economic dispatch, the coordination of off-system sales and purchases, and exchanges of energy. *See, e.g.*, Transmittal Letter at 3.

With regard to energy sales under the PSOA, which is the subject of the deficiency letter, energy from the Plants will be allocated first to ULH&P's native load requirements. PSOA § 4.01. If excess capacity at the Plants or any other ULH&P Resource (*i.e.*, capacity above that needed to serve ULH&P's native load) can be economically dispatched, energy from the Plants or other ULH&P Resource

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<sup>1</sup> The Kentucky Public Service Commission ("KyPSC") has made clear on a number of occasions that it believes ULH&P, which currently owns no generation, should own physical generation assets. In light of this direction, CG&E and ULH&P agreed to transfer from CG&E to ULH&P three electric generating stations, with a combined generating capacity of 1,105 MW (nameplate rating). *Id.* at 2-3. The KyPSC already has approved the PSOA, finding that it is "required in conjunction with the proposed transfer" of the Plants and "appears to be reasonable." *See, e.g., In the Matter of the Application of the Union Light, Heat and Power Company for a Certificate of Public Convenience to Acquire Certain Generation Resources and Related Property; for Approval of Certain Purchase Power Agreements; for Approval of Certain Accounting Treatment; and for Approval of Deviation from Requirements of KRS 278.2207 and 278.2213(6)*, Case No. 2003-00252, 2003 Ky. PUC LEXIS 1030, at p. 17 (December 5, 2003).

will be sold to CG&E as a system energy transfer under the PSOA. *Id.*<sup>2</sup> CG&E will either use that energy to serve its native load, transfer the energy to PSI as a system energy transfer under the operating agreement between CG&E and PSI, or sell the energy into the market.<sup>3</sup> Likewise, to the extent ULH&P load is not served from the Plants under joint economic dispatch, excess energy from CG&E Resources may be made available to serve ULH&P load. *Id.* § 4.01.<sup>4</sup> The Filing Parties note that, while excess capacity could be sold and purchased through the Midwest ISO Day 2 market directly rather than through the PSOA, such market sales and purchases do not provide the benefits that will be provided under the agreement. Importantly, the PSOA provides the mechanism that will allow the Filing Parties to continue to use CG&E's and ULH&P's combined resources for regulation and load following, rather than doing so on a single-company basis.

Energy transferred between the operating companies in accordance with the PSOA is priced at hourly market prices, capped at the receiving party's incremental cost. *Id.* § 4.01(b). In the September 27 filing, the Filing Parties explained that, initially, they expected market prices under the PSOA to be determined based upon actual sales quotes of hourly energy with similar characteristics to unaffiliated third parties, as there is no published index of hourly prices for the Into Cinergy Market to which transfers under the PSOA can be pegged. Transmittal Letter at 5 (citing PSOA § 4.02(b)). In hours where the companies did not make hourly transactions, the hourly market price would be determined by reference to quotes proffered by nonaffiliated parties, again capped at the receiving party's incremental cost of using its own available generating resources. *Id.* The Filing Parties also explained that "[o]nce a reliable hourly market index or clearing price comes into existence, such a

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<sup>2</sup> ULH&P Resources are defined under the PSOA as "(a) the generation assets owned from time to time by ULH&P (including ULH&P's then-current share of jointly-owned generating assets), and (b) Reliability Purchases secured by ULH&P, such Reliability Purchases including the power purchased by ULH&P solely for purposes of backing up ULH&P-owned electric generating assets." *Id.* § 1.26.

<sup>3</sup> All sales of energy from the Plants into the market, including the Midwest ISO market, thus will be made by CG&E.

<sup>4</sup> CG&E Resources are defined under the PSOA as "(a) the generation assets owned by CG&E on the Effective Date (including CG&E's then-current share of jointly-owned generation assets), to the extent that such assets continue to be owned by CG&E; (b) Reliability Purchases secured by CG&E; and (c) other purchases or generating assets, including purchases from or generating assets of non-regulated affiliates, as designated by CG&E in its sole discretion to be dispatched jointly pursuant to this Agreement." *Id.* § 1.04.

market index or clearing price will be used to determine market prices, subject to prior Commission approval." *Id.* (citing PSOA § 4.02 and Attachment A).

The Midwest ISO's Day 2 market, which is scheduled to go into effect on March 1, 2005, provides such a "reliable market clearing price." The Day 2 market will include day-ahead and real-time energy markets, locational marginal pricing to determine energy prices, financial transmission rights to provide hedges against congestion costs, and strict market monitoring and mitigation procedures. *See, e.g., Midwest Indep. Transmission Sys. Oper., Inc.*, 108 FERC ¶ 61,163, *order on reh'g*, 109 FERC ¶ 61,157 (2004) ("November 8 Order"); *Midwest Indep. Transmission Sys. Oper., Inc.*, 102 FERC ¶ 61,280 (2003). The market incorporates the major features used successfully in PJM Interconnection, L.L.C. ("PJM"), the New York Independent System Operator, Inc., and ISO New England. *See, e.g., November 8 Order*, 109 FERC ¶ 61,157 at P 1. Therefore, to address the deficiency letter, the Filing Parties propose, in accordance with Section 4.02 of the PSOA, that all energy sales under the PSOA will be priced at the applicable market clearing price in the Midwest ISO Day 2 market, and commit that the PSOA will not become effective until the Midwest ISO's Day 2 market becomes operational.<sup>5</sup>

## **II. Pricing Energy Sales Under the PSOA Using Midwest ISO Day 2 Market Prices Complies with *Edgar***

The Commission has stated, with regard to affiliate transactions, that "it is essential that ratepayers be protected and that transactions be above suspicion in order to ensure that the market is not distorted." *Allegheny Energy Supply Co., LLC*, 108 FERC ¶ 61,082 at P 18 (2004). The *Edgar* standard of review is designed to "prevent affiliate abuse and to ensure prices that would be consistent with competitive outcomes." *Southern Power Co.*, 104 FERC ¶ 61,041 at PP 21, 23 (2003); *see also Entergy Servs., Inc.*, 103 FERC ¶ 61,256 at P 49 (2003) (same). The Commission thus reviews an affiliate transaction according to *Edgar* to assure that the transaction neither (a) leads to cross-subsidization at the expense of the public utility's captive customers, nor (b) causes long-term harm to wholesale competitive markets. *Southern Calif. Edison Co.*, 109 FERC ¶ 61,086 at PP 35-36 (2004) ("*Edison II*"); *Allegheny*, 108 FERC ¶ 61,082 at P 18. Parties can show a lack of affiliate preference under *Edgar* in a number of ways, including by showing (a)

<sup>5</sup> Section 4.02 of the PSOA provides for 30 days notice to the KyPSC prior to use of an index or clearing price in place of the sales quote methodology. PSOA § 4.02(b). Because the PSOA is not currently effective, the notice requirement also is not effective. The Filing Parties note, however, that a copy of this filing, with an explanation constituting the required notice, is being mailed to the KyPSC, which is a party to this proceeding.

direct head-to-head competition between affiliated and unaffiliated suppliers; (b) comparable prices which nonaffiliated buyers were willing to pay for similar services; and (c) benchmark evidence showing the prices, terms, and conditions of sales made by nonaffiliated sellers. See, e.g., *Conectiv Energy Supply, Inc.*, 109 FERC ¶ 61,385 at P 9 (2004); *Edgar*, 55 FERC at 62,168. The Commission has been clear, however, that these three examples are "not necessarily an all-inclusive list" of the ways the *Edgar* concerns can be satisfied. *Edgar*, 55 FERC at 62,168.

Adopting Midwest ISO Day 2 market prices to price energy sales under the PSOA complies with the goals and purposes of *Edgar*, and should be found to comply with the information requirements of the deficiency letter. As the Filing Parties will explain, pricing energy transfers under the PSOA using Midwest ISO Day 2 market prices ensures that ratepayers will not be harmed by the agreement. The Filing Parties also will explain why the PSOA will not harm wholesale competitive markets. For these reasons alone the PSOA should be approved. The Filing Parties nonetheless also will explain why, even if one of the three criteria identified in *Edgar* must be shown, pricing under the PSOA will reflect direct head-to-head competition between affiliated and unaffiliated suppliers.

**A. Ratepayers are Fully Protected Under the PSOA**

To assure that ratepayers are adequately protected under the PSOA, the Commission must assure that sale prices between the affiliates are neither "too low" nor "too high." See, e.g., *Pinnacle West Capital Corp.*, 91 FERC ¶ 61,290 at 61,998 (2000). If they are too low or high, costs could be absorbed by captive ratepayers. *Id.* Here, there is no question that ratepayers are fully protected against any possible concerns of affiliate abuse.

The Commission already has concluded that tying the price of an affiliate transaction to an established, relevant market price adequately mitigates any affiliate abuse concerns. *Portland General Elec. Co.*, 96 FERC ¶ 61,093 at 61,378 (2001); *FirstEnergy Trading Servs., Inc.*, 88 FERC ¶ 61,067 at 61,156 (1999); cf. *Aquila, Inc.*, 101 FERC ¶ 61,331 (2002) (setting affiliate transaction for hearing to determine whether power sale from utility to unregulated affiliate "was not below the relevant market price"); *Pinnacle West*, 91 FERC at 61,998 (ratepayers can be harmed "if the public utility can sell power to its affiliated power marketer at below-market prices or if the power marketing affiliate can sell power to the public utility at a price above the prevailing market price"). In *FirstEnergy*, for example, the Commission approved energy sales from a power marketer to its affiliated public utility precisely because those sales were set at the relevant hourly locational price determined by

PJM. *FirstEnergy*, 88 FERC at 61,156.<sup>6</sup> Because all energy transfers under the PSO—which are the only sales made under that agreement—will be made at prices determined in the Midwest ISO Day 2 market, ratepayers will be provided full protection against affiliate abuse concerns. Like PJM, the Midwest ISO's market prices will be transparent, will be determined through centrally cleared markets that will include rules consistent with practices in the other centrally dispatched markets that currently are operational, and will be subject to strict market monitoring standards. November 8 Order, 109 FERC ¶ 61,157 at P 3.

The conclusion that use of Midwest ISO Day 2 market prices fully protects ratepayers against affiliate abuse concerns is further bolstered by the Commission's "repeated[]" holdings that prices for affiliate transactions may be set "by reference to competitive prices at recognized market hubs." *Arizona Pub. Serv. Co.*, 101 FERC ¶ 61,028 at P 5 (2002). The Commission will accept a particular price index so long as that index assures the Commission "that the affiliates are transacting at the prevailing market price." *Richmond County Power*, 96 FERC ¶ 61,149 at 61,642 (2001); *see also Pinnacle West*, 91 FERC at 61,998 (Commission accepting proposal to cap prices based on the Palo Verde Index "because the Palo Verde Index is an open, transparent, well-recognized index of market prices in the Palo Verde region and because [the seller] does not control prices under the Palo Verde Index."). Here, the prices for energy transferred under the PSO will equal *actual* prevailing market prices, *i.e.*, the applicable prices determined through the Midwest ISO Day 2 market, not by a price index.<sup>7</sup>

#### **B. Competition Will Not be Harmed by the PSO**

The Commission has identified two types of harm to competition that can arise from affiliate transactions. First, the Commission has stated that competition is harmed when one affiliate purchases from another affiliate even though lower cost resources are available from non-affiliated suppliers. *See, e.g., Ameren Corp.*, 108 FERC ¶ 61,094 at P 78 (2004); *Southern California Edison Co.*, 106 FERC ¶ 61,183

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<sup>6</sup> The Commission also has made clear that no further customer protections are required when affiliate sales are made at established market prices. *Portland General*, 96 FERC at 61,378; *see also FirstEnergy*, 88 FERC at 61,156 (approval based solely on use of market price).

<sup>7</sup> Because prices under the PSO will be determined by actual market prices, not index prices, the Price Index Policy Statement, *Price Discovery in Natural Gas and Elec. Markets*, 104 FERC ¶ 61,121 (2003), and the Price Index Order, *Price Discovery in Natural Gas and Elec. Markets*, 109 FERC ¶ 61,184 (2004), do not apply here.



at PP 58-59 (2004) ("*Edison I*"), *order on reh'g, Edison II*. Second, the Commission has stated that competition is harmed if an affiliate transaction provides a "safety net" for one affiliate. With regard to the latter, the Commission initially concluded that transfers of generating facilities from merchant generating companies to affiliated, regulated public utilities can raise market power concerns because they can provide a safety net for the generating companies when market conditions decline. *See, e.g., Cinergy Servs. Inc.*, 102 FERC ¶ 61,128 at P 23 (2003). The Commission later stated that similar concerns arise with power purchase transactions among regulated and unregulated affiliates. *See, e.g., Entergy*, 103 FERC ¶ 61,256 at P 49. As the Filing Parties explain below, neither concern arises under the PSOA.

By setting the price under the PSOA at the relevant Midwest ISO Day 2 market clearing price, there is no incentive to engage in an affiliate sale when less expensive resources are available from non-affiliated suppliers. The Filing Party that is purchasing energy will pay the same price whether it purchases energy produced by its affiliate or energy purchased from the market—the applicable Midwest ISO Day 2 market price. If an affiliated seller were to engage in an affiliate sale when less expensive resources are available from non-affiliated suppliers, that is when its cost of generating power exceeds the market price, it would lose by making a sale under the PSOA, as the payment it would receive (the Midwest ISO Day 2 market clearing price) would not be sufficient to cover its incremental costs. The affiliated seller thus is better off refraining from making such an uneconomic sale from a displaceable resource (*i.e.*, a resource that does not have to run at specific levels for operational reasons) and allowing its affiliate to make purchases at market. Because there is no incentive for either party to enter into an affiliate transaction when lower cost resources are available from non-affiliated suppliers there is no basis to find that competition will be harmed by the PSOA. *Ameren*, 108 FERC ¶ 61,094 at P 78 (finding no harm to the market when there is no incentive to overpay under an affiliate agreement).<sup>8</sup> The Filing Parties also note that the fact that purchases may be made through the PSOA rather than through the Midwest ISO market does not provide a basis for finding that competition is harmed. *Edison I*, 106 FERC ¶ 61,183 at P 62.

The PSOA also does not raise any "safety net" concerns. By pricing the energy sales under the PSOA at the market price the selling affiliate is receiving the same amount of revenues it would receive by selling its energy into the Midwest ISO

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<sup>8</sup> As noted above, excess capacity could be sold and purchased through the Midwest ISO Day 2 market rather than through the PSOA. Such market sales and purchases, however, do not provide the benefits that will be provided under the PSOA. *See supra*, Section I.

market. The selling affiliate thus is not receiving any additional revenues or protections from selling under the PSOA. In any event, this transaction does not involve a purchase by a regulated utility from an unregulated affiliate, which is when the Commission has expressed concerns with "safety nets" in the past. The PSOA instead is a joint operating agreement among physically adjacent, integrated operating companies in a holding company system. Joint operating agreements often are established to provide the rates, terms, and conditions for joint dispatch and operation of integrated holding company systems.

**C. Prices Under the PSOA Will Reflect Direct Head-to-Head Competition Between Affiliated and Unaffiliated Suppliers**

In *Edgar* the Commission stated that parties can show a lack of affiliate preference in a number of ways, including by showing (a) direct head-to-head competition between affiliated and unaffiliated suppliers; (b) comparable prices which nonaffiliated buyers were willing to pay for similar services; and (c) benchmark evidence showing the prices, terms, and conditions of sales made by nonaffiliated sellers. *See, e.g., Edgar*, 55 FERC at 62,168. The Commission made clear, however, that these three examples are "not necessarily an all-inclusive list" of the ways the *Edgar* concerns can be satisfied. *Id.* at 62,168. In fact, as explained above the Commission since *Edgar* has on many occasions approved affiliate transactions when prices either are tied to an established, relevant market price or established by reference to recognized market price indices. The Filing Parties thus do not believe that any showing beyond that made above is necessary for the Commission to approve the PSOA.

Even if an additional showing were required, however, the Commission should find that pricing energy sales under the PSOA using Midwest ISO Day 2 market prices reflects direct head-to-head competition between affiliated and unaffiliated suppliers. First, to the extent the market price is lower than the Filing Parties' incremental cost to produce energy the Filing Parties will purchase energy from the market. As explained above, there is no incentive for the Filing Parties to engage in an affiliate transaction under the PSOA when cheaper energy is available in the market. Second, the entire Midwest ISO region will be a single geographic market, and market outcomes will be based on the interplay of market forces in that entire region. *Cf. Alliant Energy Corp. Serv., Inc.*, 109 FERC ¶ 61,289 at P 4 (2003) (once the Midwest ISO becomes a single market and performs functions such as single central commitment and dispatch with Commission-approved market monitoring and mitigation, Midwest ISO will be considered to have a single geographic market for purposes of generation dominance screens); *AEP Power Marketing, Inc.*, 108 FERC ¶ 61,026 at PP 31-36 (2004) (absent a showing of persistent transmission constraints, the entire regional transmission organization

should be considered the default relevant geographic market for market power analyses). Market outcomes thus will reflect the interplay of many sellers and buyers. Third, the Filing Parties' transmission assets are subject to the control of the Midwest ISO, and cannot be used to impede competition. *See Edison II*, 109 FERC ¶ 61,086 at P 41 (finding no monopsony power when transmission system subject to independent control). The Filing Parties' resources thus will be in direct head-to-head competition with unaffiliated suppliers.

The Commission generally has considered the first prong of the *Edgar* test when addressing affiliate transactions that result from a request for proposals or some other form of bilateral negotiations, not when, as here, prices are established based on actual market prices. In those other circumstances, the Commission seeks assurances that:

- (1) the solicitation or negotiation was designed and implemented without undue preference for the affiliate, (2) the analysis of the bids or responses did not favor the affiliate, particularly with respect to evaluation of nonprice factors, and (3) the affiliate was selected based on some reasonable combination of price and nonprice factors.

*Edgar*, 55 FERC at 62,168. Here there can be no question that each of these criteria are satisfied. The market prices being compared to the Filing Parties' incremental costs will be transparent and will be determined pursuant to a centralized market operated by the independent Midwest ISO. Further, as explained above, because pricing under the PSOA will be based on Midwest ISO Day 2 market prices there is no incentive for either party to enter into an affiliate transaction when lower cost resources are available from non-affiliated suppliers. Finally, nonprice factors will not need to be considered—the comparison under the PSOA will be one based strictly on price.

### **III. Notice of Filing**

The Filing Parties are including herewith a Notice of Filing of this response, in hard copy and on diskette.

### **IV. Conclusion**

The Filing Parties request that the Commission approve the PSOA as requested in the September 27 filing and as further explained herein. Please contact the undersigned should you require any additional information.

Magalie R. Salas  
January 26, 2005  
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Respectfully submitted,

A handwritten signature in black ink, appearing to read "Mike Naeve", with a horizontal line drawn underneath it.

Mike Naeve  
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cc: Diane Gruenke  
Office of Markets, Tariffs and Rates - Central

**NOTICE OF FILING**

The Union Light, Heat and )  
Power Company ) Docket No. ER04-1248-001  
The Cincinnati Gas & Electric Company )

( )

This filing is accessible on-line at <http://www.ferc.gov>, using the "eLibrary" link and is available for review in the Commission's Public Reference Room in Washington, D.C. There is an "eSubscription" link on the web site that enables subscribers to receive email notification when a document is added to a subscribed docket(s). For assistance with any FERC Online service, please email

[FERCOnlineSupport@ferc.gov](mailto:FERCOnlineSupport@ferc.gov), or call (866) 208-3676 (toll free). For TTY, call (202) 502-8659.

Comment Date: 5:00 pm Eastern Time on [date].


Linda Mitry  
Deputy Secretary

**CERTIFICATE OF SERVICE**



**CERTIFICATE OF SERVICE**

I hereby certify that I have this day caused to be served the foregoing document via first class mail, postage pre-paid, upon each person designated on the official service list compiled by the Secretary in these proceedings. Dated at Washington, D.C., this 26<sup>th</sup> day of January, 2005.

A handwritten signature in black ink, appearing to read 'Glen Bernstein', is written over a horizontal line.

Glen Bernstein  
Skadden, Arps, Slate, Meagher  
& Flom LLP  
1440 New York Avenue, N.W.  
Washington, D.C. 20005-2111

## **PURCHASE, SALES AND OPERATION AGREEMENT**

This Purchase, Sales and Operation Agreement ("Agreement" or "PSOA") is made and entered into this 27th day of September, 2004, by and among The Cincinnati Gas & Electric Company ("CG&E"), The Union Light, Heat and Power Company ("ULH&P") and Cinergy Services, Inc. ("Services"), all of whom are direct or indirect subsidiaries of Cinergy Corp. ("Parent Company" or "Cinergy").

### **WITNESSETH:**

WHEREAS, ULH&P has acquired certain generating resources from CG&E for the purpose of generating and selling electric energy to the general public; and

WHEREAS, CG&E is the owner and operator of, among other things, electric generation facilities, which, as a result of Ohio Rev. Code Ann. Sections 4928.01 *et seq.* are no longer subject to regulation by the PUCO as of January 1, 2001; and

WHEREAS, it is the intention of the Parties that nothing in this Agreement shall in any way limit the ability of CG&E to sell, transfer, lease or otherwise dispose of such electric generation facilities to an affiliate or third party, whether by sale, merger, joint venture or otherwise, at any time and from time to time; and

WHEREAS, Services is an associated service company acting as the agent for CG&E and ULH&P; and

WHEREAS, the Parties desire that the Cinergy Resources and ULH&P Resources continue for the present time to be operated as an integrated system and economically dispatched in accordance with the terms and conditions hereof; and

WHEREAS, the Parties intend that this Agreement shall operate separately and independently from, and shall have no affect on, the Joint Generation Dispatch Agreement dated October 26, 2001 by and among CG&E, Cinergy Power Investments, Inc. (on its own behalf and as agent for its Exempt Wholesale Generator subsidiaries), PSI Energy, Inc. (PSI) and Services (JGDA); and

NOW, THEREFORE, the Parties mutually agree and covenant as follows:

### **ARTICLE I DEFINITIONS**

1.01 Agreement shall mean this Purchase, Sales and Operating Agreement ("PSOA").

- 1.02 Buy-Sell Transactions shall mean any transactions whereby energy and any associated capacity is simultaneously purchased from a third party and resold to another third party under applicable FERC rate schedules.
- 1.03 CG&E's Native Load Customers shall mean (a) CG&E's retail electric customers served by CG&E pursuant to tariffs or contracts as approved by the PUCO (including customers served by CG&E as the "supplier of last resort"); (b) CG&E's total requirements wholesale electric customers served pursuant to traditional cost of service tariffs as approved and regulated by the FERC; and (c) ULH&P solely to the extent of power purchased by ULH&P from CG&E to backup ULH&P-owned generating assets.
- 1.04 CG&E Resources shall mean (a) the generation assets owned by CG&E on the Effective Date (including CG&E's then-current share of jointly-owned generation assets), to the extent that such assets continue to be owned by CG&E; (b) Reliability Purchases secured by CG&E; and (c) other purchases or generating assets, including purchases from or generating assets of non-regulated affiliates, as designated by CG&E in its sole discretion to be dispatched jointly pursuant to this Agreement.
- 1.05 Cinergy Resources shall mean those CG&E Resources and PSI Resources subject to the JGDA.
- 1.06 Economy Purchases shall mean purchases entered into when and because the cost of power offered for sale in the wholesale market is less than the Incremental Cost of displaceable Generating Resources or Operating Purchases previously obtained and available.
- 1.07 Effective Date shall mean September 27, 2004 or such later date as may be fixed by any requisite regulatory approval or acceptance for filing.
- 1.08 FERC shall mean the Federal Energy Regulatory Commission or any successor agency.
- 1.09 Generating Resources shall mean the ULH&P Resources and the Cinergy Resources that are subject to this Agreement.
- 1.10 Incremental Cost shall mean the variable costs required to produce a specified block of energy, including fuel costs, variable operations and maintenance costs, start-up costs, incremental taxes, regulatory commission charges, transmission losses, variable charges for use of transmission facilities and the costs of emission allowances. Among the Parties, emission allowances may be reimbursed in kind.
- 1.11 KyPSC shall mean the Kentucky Public Service Commission or any successor agency.

- 1.12 Load Requirements shall mean the demand and energy requirements of ULH&P's and/or CG&E's Native Load Customers.
- 1.13 Market Price shall mean the applicable hourly energy price at which the supplier could have sold the energy into the wholesale market if the exchange of energy between the Operating Companies did not take place, calculated in accordance with Section 4.02(b) and Service Schedule A.
- 1.14 Native Load Customers shall mean ULH&P's Native Load Customers and/or CG&E's Native Load Customers.
- 1.15 Off-System Purchases shall mean purchases from a third party of energy and/or associated capacity to reduce costs and/or to provide reliability for the electric utility system of ULH&P or CG&E, excluding in each case Buy-Sell Transactions.
- 1.16 Off-System Sales shall mean sales of electricity by ULH&P or by CG&E, other than Load Requirements whether inside or outside the Cinergy Control Area, excluding in each case Buy-Sell Transactions and trading activities.
- 1.17 Operating Company(ies) shall mean CG&E and/or ULH&P.
- 1.18 Operating Purchases shall mean short-term purchases entered into when and because Generating Resources are fully utilized and Native Load Customers' Load Requirements cannot be fully met with such Generating Resources.
- 1.19 Parent Company shall mean Cinergy Corp.
- 1.20 Party(ies) shall mean ULH&P, CG&E, and/or Services.
- 1.21 PUCO shall mean the Public Utilities Commission of Ohio or any successor agency.
- 1.22 Reliability Purchases shall mean purchases of energy and/or capacity made in order to have adequate reserves (or an adequate Reserve Margin) to serve the forecasted Load Requirements of Native Load Customers.
- 1.23 Reserve or Reserve Margin shall mean the amount of generating capacity forecasted to be available (owned or purchased) to ULH&P or CG&E above the forecasted load for that system. For purposes of this Agreement, Reserve Margin shall include supply-side resources owned or under contract including: units, Reliability Purchases, cogeneration contracts, and, to the extent not captured in the utility's load forecast, reasonable expectations of load reductions from customer demand-side management programs, interruptible and other customer-

specific contracts, and market-based electricity pricing programs that provide customers with non-elective peak load reduction incentives.

- 1.24 System Economic Dispatch shall mean the centralized commitment and loading of resources existing and available including Generating Resources, Economy Purchases, and Operating Purchases (if necessary), taking into consideration standard industry dispatch input information such as fuel costs, heat rates, unit start-up costs and start-up times, ramp rates and ramp time, minimum run and minimum down times, contribution to reserves, regulatory requirements, minimum and maximum capacity, and other engineering and operational constraints such that the cost of meeting demand requirements is minimized to the greatest extent practicable. Such economic dispatch shall reflect the market value of sulfur dioxide emission allowances and any other similar emission allowances (such as NO<sub>x</sub> emission allowances) if applicable (i.e., “environmentally affected dispatch”).
- 1.25 ULH&P’s Native Load Customers shall mean (a) ULH&P’s retail electric customers served pursuant to traditional cost of service tariffs or contracts as approved and regulated by the KyPSC.
- 1.26 ULH&P Resources shall mean (a) the generation assets owned from time to time by ULH&P (including ULH&P’s then-current share of jointly-owned generating assets), and (b) Reliability Purchases secured by ULH&P, such Reliability Purchases including the power purchased by ULH&P solely for purposes of backing up ULH&P-owned electric generating assets.

## ARTICLE II TERM OF AGREEMENT

- 2.01 This Agreement shall take effect on the Effective Date and shall continue until terminated.
- 2.02 This Agreement shall terminate by its own terms upon any Party providing the other Parties at least thirty (30) days written notice of termination. It is the intention of the Parties that such termination shall occur without regulatory approval.

**ARTICLE III  
MISCELLANEOUS PROVISIONS**

- 3.01 Effectiveness of Agreement. The effectiveness of this Agreement is subject to receipt of all necessary regulatory approvals in form and substance satisfactory to each of the Parties.
- 3.02 Books and Records. The FERC and the KyPSC shall have access to the books and records of ULH&P and CG&E as necessary to determine compliance with this Agreement.
- 3.03 Billings. Bills for services rendered hereunder shall be calculated in accordance with the provisions of this Agreement and paid by the twentieth (20<sup>th</sup>) day of each month.
- 3.04 Waivers. Any waiver at any time by a Party of its rights with respect to a default by any other Party under this Agreement or any other matter arising in connection with this Agreement shall not be deemed a waiver with respect to any subsequent default or matter.
- 3.05 PSOA Administrative Operating Committee.
- a. A PSOA Administrative Operating Committee will be formed and will consist of members from each of the Operating Company Parties to this Agreement (i.e., ULH&P and CG&E). Such membership may change, from time to time. One or more of the members of the Committee shall be designated to function as ULH&P's representative(s) on the Committee. ULH&P and CG&E shall have equal representation on the Committee.
  - b. The duties of the PSOA Administrative Operating Committee shall include: (1) the day-to-day administration of this Agreement; (2) consistent with Section 4.08, determination of the amount of and monitoring acquisition of adequate reserves for each Operating Company; (3) consistent with Sections 4.03 and 4.08, coordination of arrangements to procure the purchase of capacity and/or energy from external sources; and (4) any other duties that may, from time to time, be assigned or deemed appropriate.
  - c. In connection with items b. (2) and (3) above, the PSOA Administrative Operating Committee shall document its decisions and related discussions concerning determination of adequate reserves and procurement of Reliability Purchases.
  - d. The PSOA Administrative Operating Committee shall also cause to be documented the need and rationale for emergency purchase decisions.
- 3.06 Amendment.

- a. This Agreement may be changed, amended, or supplemented only by an instrument in writing, signed by all the Parties.
- b. Before the Parties file any amendment to this Agreement with FERC for its approval, ULH&P must first submit such proposed amendment to the KyPSC.
- c. ULH&P agrees to negotiate in good faith with the KyPSC Staff and interested Kentucky customer groups concerning any proposed amendments.
- d. In the event that a proposed amendment is at any time finally rejected, disapproved, or found to be unreasonable by the KyPSC, or if the KyPSC fails to take final action concerning a proposed amendment within a ninety (90) day period of time, the Parties shall have the right to file a proposed amendment(s) with the FERC for approval. The FERC shall be the final arbiter concerning the justness and reasonableness of any such proposed amendment(s).

3.07 Successors and Assigns.

This Agreement shall inure to the benefit of and be binding upon the Parties only, and their respective successors and assigns, and shall not be assignable by any Party without the written consent of the other Parties except to a successor in the operation of its properties by reason of a reorganization to comply with state or federal restructuring requirements, or a merger, consolidation, sale or foreclosure whereby all or substantially all such properties are acquired by or merged with those of such a successor.

3.08 No Third Party Beneficiaries.

This Agreement does not create rights of any character whatsoever in favor of any person, corporation, association, entity, customer or power supplier, other than the Parties, and the obligations herein assumed by the Parties are solely for the use and benefit of said Parties. Nothing in this Agreement shall be construed as permitting or vesting, or attempting to permit or vest, in any person, corporation, association, entity, customer or power supplier, other than the Parties, any rights hereunder or in any of the resources or facilities owned or controlled by the Parties or the use thereof.

## ARTICLE IV

### ASSIGNMENT OF THE COSTS AND BENEFITS OF JOINT DISPATCH

4.01 System Dispatch.

- a. The ULH&P Resources and the Cinergy Resources will be operated and dispatched on an integrated basis. The Parties will incorporate the effects of Reliability Purchases in the economic dispatch process; however, the generating resources owned by entities other than ULH&P or CG&E that provide Reliability Purchases to one or more of the Parties are not themselves

subject to the system dispatch provisions of the Agreement. Generating unit commitment and dispatch decisions will be made on an economic basis consistent with security constraints. The ULH&P Resources will first be allocated to ULH&P's Load Requirements; the CG&E Resources will first be allocated to CG&E's Load Requirements. If ULH&P's Load Requirements or CG&E's Load Requirements cannot be met by dispatched ULH&P Resources or CG&E Resources, respectively, energy transfers from the other Operating Company, if available, or purchases will be implemented on an economic dispatch basis. ULH&P Native Load Customers will have the benefit of "first call" on ULH&P Resources.

- b. Irrespective of any other provisions of this Agreement, the amount paid for energy transferred between the Parties shall not exceed the receiving Party's incremental cost of using its own Generating Resources (to the extent actually available), consistent with System Economic Dispatch.

4.02 Energy Transfers.

- a. Energy transferred from one Operating Company to the other will be reimbursed at Market Price, in accordance with Service Schedule A, attached hereto and incorporated by reference into this Agreement. The books and records of the supplying Operating Company shall so reflect such reimbursements, and the books and records of the Parties shall be available to the FERC and the KyPSC as necessary to determine compliance with this provision. In lieu of monetary reimbursement for the value of emission allowances used in environmentally affected dispatch, the Operating Companies may provide the supplying Operating Company with the required number of emission allowances, and the value of such emission allowances as utilized in System Dispatch shall be reflected as a credit to the Market Price. Any transfer of SO<sub>2</sub>, NO<sub>x</sub> and other pollutant emission allowances between Operating Companies will be at a price consistent with the market price for such emission allowances used for environmentally affected dispatch, or shall be reimbursed in kind. Each Party shall be permitted to retain all proceeds and benefits accruing from energy transfers it makes to the other Party.
- b. Market Price will be determined by reference to actual sales quotes of hourly energy with similar characteristics to unaffiliated third parties. The Parties agree to obtain independently audited hourly market price quotes and to provide both the FERC and the KyPSC with access to such independently audited quotes that form the basis for the system energy transfer Market Prices. If ULH&P reasonably concludes that a reliable market index or clearing price for setting the price between the Parties has come into existence, within a reasonable period of time after reaching such conclusion, ULH&P shall seek FERC approval for the use of such an index or clearing price in place of reliance upon the sales quotes methodology set forth in this subpart; provided, however, that ULH&P must provide at least thirty (30) days notice to the KyPSC prior to seeking such FERC approval.



Determination of Market Price is further subject to the provisions set forth in Service Schedule A.

- c. For fuel adjustment charge purposes, so long as such system energy transfers are made at Market Price, such system energy transfers shall be treated the same as energy purchases from the hourly wholesale power market from unaffiliated third parties. Provided, however, that, ULH&P shall, in its fuel adjustment charge proceedings, identify the amounts and prices of system energy transfers for which ULH&P seeks rate recovery.
- d. Power purchased by ULH&P from CG&E specifically for purposes of backing up ULH&P-owned generating assets shall not be considered energy transfers under this Agreement.

4.03 Off-System Purchases.

- a. Economy Purchases – The Operating Companies will make Economy Purchases on a coordinated basis when Economy Purchases can be made from the market more economically than energy can be generated from Generating Resources. The average hourly costs of such Economy Purchases will be allocated between the Operating Companies based on the respective hourly amount of energy of each of the Operating Companies displaced by the purchase in the context of economic dispatch of the System.
- b. Operating Purchases – The Operating Companies will make Operating Purchases on a coordinated basis when such purchases are necessary to meet Native Load Customers' Load Requirements. The average hourly costs of such Operating Purchases will be allocated between the Operating Companies based on the respective hourly needs of the Operating Companies.
- c. Reliability Purchases – Consistent with Section 4.08 and Section 3.05, from time to time, the Operating Companies shall each determine the amount and type of Reliability Purchases necessary to adequately and reliably meet their respective anticipated Load Requirements (including a Reserve Margin). Reliability Purchases made solely for one Operating Company, in consideration of operating or economic criteria for that Company that differ from those applicable to the other Company, will be assigned to that Operating Company at the time of purchase. Reliability Purchases made for both Operating Companies will be allocated to the Operating Companies at the time of purchase in proportion to the projected needs of each Operating Company for that type of purchase, not to exceed the projected needs of each Operating Company.

4.04 Off-System Sales. The Operating Companies will coordinate the sale of excess energy of the Generating Resources. Once ULH&P Load Requirements are satisfied, any excess energy from the ULH&P Resources will be available for transfer to CG&E, for CG&E's Load Requirements, and/or to transfer to PSI under the terms of the JGDA and/or to sell into the wholesale market. Any transfer to CG&E will occur at Market Price. Once CG&E Load Requirements are satisfied, any excess energy from the Cinergy Resources will be available for

transfer to ULH&P for ULH&P's Load Requirements. Any transfer to ULH&P will occur at Market Price.

- 4.05 Generating Resources. Except as expressly provided herein, each Operating Company will be assigned all of the fixed and variable costs and related benefits of its Generating Resources for all purposes relevant to this Agreement. Without limiting the foregoing, the fixed and variable costs and related benefits of generating unit retirements, permanent derates, or removal from rate base, or of improving any such generating units, whether it be routine component replacement, or improvements to maintain unit reliability, will be assigned to the Operating Company owning the generating unit.
- 4.06 Maintenance Scheduling. Generating unit maintenance outage scheduling will be performed on an integrated system basis. ULH&P and CG&E Native Load Customer's Load Requirements will be determined, and based on total available energy supply, maintenance will be scheduled subject to system reliability constraints. To the extent that flexibility exists in the scheduling of maintenance, such outages will be scheduled in a manner that fairly allocates the risk among Parties of exposure to the need for summer electricity purchases.
- 4.07 Additional Generation. To the extent an Operating Company constructs or acquires additional generation in the future, the costs and benefits thereof shall be borne by and accrue to the Operating Company owning such generating units.
- 4.08 Capacity Planning. This Agreement does not obligate the Parties to engage in joint capacity planning. However, ULH&P and CG&E will each meet the minimum operating Reserve requirements (as imposed by ECAR, NERC, or RTO requirements, as applicable). Beyond those minimum operating Reserve requirements, ULH&P and CG&E will each individually determine their respective forecasted Reserve Margin needs for the upcoming peak season(s). Further, ULH&P and CG&E will each have the discretion and the flexibility to meet their respective short-term forecasted Reserve Margin needs in such manner as each deems appropriate.
- 4.09 Curtailment Protocols. On the Effective Date, ULH&P and CG&E shall have in place curtailment protocols adequate to ensure that neither Operating Company's Native Load Customers subsidize the other Operating Company's Native Load Customers in the event of load curtailments.
- 4.10 Future ULH&P Capacity. Unless otherwise provided by law, regulation or order, any future generating capacity that ULH&P constructs or acquires for its Load Requirements will be dedicated first to serve ULH&P's Native Load Customers. Construction or acquisition approval and rate recovery for capacity additions will occur through the applicable Certificate of Public Convenience and Necessity ("CPCN") and rate case process and/or any other applicable statutory provisions.

- 4.11 Disposition of CG&E Generation. Nothing in this Agreement shall limit the ability of CG&E to sell, transfer, swap, lease or otherwise alienate or dispose of all or part of the CG&E Resources, or any or all of the output thereof (capacity and/or energy) from time to time to an affiliate, joint venture entity, or unaffiliated third party, whether by sale, merger, joint venture, or otherwise. In such event, so long as such sale, transfer, swap, lease, etc., is to an unaffiliated third party(ies), or to a joint venture(s), partnership(s) or similar entity(ies) in which totally unaffiliated third parties are real and substantial members or participants along with a Cinergy company(ies), at CG&E's option such CG&E Resources will no longer be subject, either directly or indirectly, to the provisions of this Agreement. For purposes of this subsection, a substantial member or participant shall be one with an ownership interest of more than ten percent (10%).
- 4.12 Transfer of CG&E Load Obligation. If CG&E contractually transfers part or all of its obligation to serve CG&E's Load Requirements to supplier(s) other than CG&E, the generating resources of such supplier(s) shall not be subject to the provisions of this Agreement.
- 4.13 No Constraint on Ohio Law. Nothing in this PSOA shall be interpreted to limit or in any way constrain CG&E's ability to comply with Ohio laws and regulations concerning electric supply matters, or to otherwise require CG&E to meet its electric supply obligations in other than a cost-effective and reliable manner. CG&E shall have the sole right and the discretion to select purchases it deems to be optimal, in its sole judgment, to serve all or part of its load obligations.

IN WITNESS WHEREOF each of the Parties has caused this Agreement to be executed and attested by its duly authorized representatives.

Attest

\_\_\_\_\_

**The Cincinnati Gas & Electric Company**

By: \_\_\_\_\_

Date: \_\_\_\_\_

Attest

\_\_\_\_\_

**The Union Light, Heat and Power Company**

By: \_\_\_\_\_

Date: \_\_\_\_\_

Attest

\_\_\_\_\_

**Cinergy Services, Inc.**

By: \_\_\_\_\_

Date: \_\_\_\_\_

## **SERVICE SCHEDULE A**

### **PRICING FOR HOURLY SYSTEM ENERGY EXCHANGES**

#### **A1 – Duration**

This Service Schedule A shall become effective and binding when the Purchase, Sales and Operation Agreement becomes effective, and shall continue in full force and effect throughout the duration of such Agreement. This Service Schedule A is a part of the Agreement and, as such, the use of terms in this Service Schedule A that are defined in the Agreement shall have the same meanings as set forth in the Agreement.

This Service Schedule shall survive termination of the Agreement if so desired by the Parties, for a period not to exceed one hundred and eighty (180) days.

#### **A2 – Hourly Energy Transfer Price**

Energy made available by either CG&E or ULH&P to the other on an hourly basis, as provided in Sections 4.01 and/or 4.02 of the Agreement or, in the event of termination of the PSOA and survival of this Service Schedule A, as provided herein, shall be priced at the Market Price, which shall be determined by reference to the following:

Market Price will be determined by reference to actual sales quotes of hourly energy with similar characteristics to unaffiliated third parties. The Parties agree to obtain independently audited hourly market price quotes and to provide both the FERC and the KyPSC with access to such independently audited quotes that form the basis for the system energy transfer Market Prices. For each hour in which energy transfers occur, the information to be recorded and retained shall include but shall not be limited to the following: (1) the identity of each counterparty contacted; (2) the price offered by each counterparty; and (3) the amount of power offered at that price by each counterparty. Such records shall be retained for three (3) years for purposes of any audit or other regulatory requirement imposed by the FERC or the KyPSC.

If ULH&P reasonably concludes that a reliable market index or clearing price for setting the price between the Parties has come into existence, within a reasonable period of time after reaching such conclusion, ULH&P shall seek FERC approval for the use of such an index or clearing price in place of reliance upon the sales quotes methodology set forth in this subpart; provided, however, that ULH&P must provide at least thirty (30) days notice to the KyPSC prior to seeking such FERC approval.

In the event that the PSOA is terminated and this Service Schedule A survives termination as provided above, irrespective of the other provisions of this Service Schedule, the amount paid for energy transferred between Parties shall not exceed the receiving Party's incremental cost of using its own Generating Resources (to the extent actually available), consistent with single-system economic dispatch, taking into account standard industry dispatch practices such as those referenced in section 1.24 of the PSOA.

The PSOA Administrative Operating Committee or its designee shall make any determinations necessary to implement the foregoing Hourly Energy Transfer Price provisions.